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ABSTRACT

The brief introductory section of this publication outlines the purpose, terms, and eligibility requirements of a model dependent care assistance plan, which is designed to assist corporation employees in the care of qualified dependents (either children under age 15 or other individuals physically or mentally incapable of caring for themselves). In the second section, a summary of federal and California tax provisions relating to child care is provided. (MP)

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MODEL
DEPENDENT CARE ASSISTANCE PLAN

AND

SUMMARY OF FEDERAL AND CALIFORNIA
TAX PROVISIONS RELATED TO CHILD CARE
FOR AND AFTER 1982

Prepared for the

CHILD CARE LAW CENTER

BY

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NOTE: THIS IS A SAMPLE PLAN. EMPLOYERS SHOULD CONSULT THEIR OWN TAX ATTORNEYS OR ADVISORS WITH RESPECT TO ADOPTION AND IMPLEMENTATION OF ANY DEPENDENT CARE ASSISTANCE PROGRAM.

ABC CORPORATION
DEPENDENT CARE ASSISTANCE PLAN*

1. Purpose.

ABC Corporation (the "Company") wishes to assist its employees in the care of their qualified dependents and therefore has adopted the ABC Corporation Dependent Care Assistance Plan (the "Plan") set out herein for the exclusive benefit of those employees who are eligible to participate in the Plan. The Plan is intended to qualify as a dependent care assistance program under section 129 of the Internal Revenue Code of 1954, as amended (the "Code") and shall be construed to comply with Code section 129.

2. Definitions.

The following terms are defined for purposes of the Plan and are indicated by capitalized initial letters wherever they appear in the Plan:

a. "Dependent" shall mean (i) any child of an Employee who is under age 15 or who is physically or mentally incapable of caring for himself or herself and with respect to whom the Employee is entitled to claim an exemption for Federal income tax purposes or who is in the custody of the Employee for at least six months during the calendar year; and (ii) a spouse of the employee who is physically or mentally incapable of caring for himself or herself.

b. "Employee" shall mean any person employed by the Company any portion of whose income is subject to withholding of income tax and/or for whom Social Security contributions are made by the Company, as well as any other person qualifying as a common law employee of the Company.

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* Additional plan provisions will apply and other considerations will pertain if the plan is an "employee welfare benefit plan" as defined in section 3(3) of the Employee Retirement Income Security Act of 1974, as amended.

c. "Dependent Care Expenses" shall mean amounts paid for the care of a Dependent in the Employee's home or at a dependent care facility which meets all applicable requirements of state or local law or is exempt from such requirements under the state or local law in question and amounts paid for related household services, except that the following items shall not be considered Dependent Care Expenses:

(i) Amounts paid to a person with respect to whom the employee or his or her spouse is entitled to claim an exemption for Federal income tax purposes;

(ii) Amounts paid to a child of the employee who is 18 years of age or younger; and

(iii) Amounts paid for or reimbursed under another plan of the Company or to which the Company contributed on behalf of the employee, under any Federal, state or local program of dependent care assistance, or by an employer of the spouse or by an educational institution where the spouse is an enrolled student.

3. Effective Date.

The Plan shall be effective on _____.

4. Eligible Employees.

All employees of the Company shall be eligible to participate in the Plan.

5. Reimbursement of Expenses for Dependent Care.

a. Upon application of the Employee, accompanied by a bill, receipt, cancelled check, or other written evidence of payment or of the obligation to pay Dependent Care Expenses, the Company will reimburse the Employee for Dependent Care Expenses incurred in order to enable the Employee to be employed by the Company, subject to the limits of paragraph b. The Company reserves the right to verify all claimed expenses prior to reimbursement.

b. Limitation on Benefits. The maximum amount of Dependent Care Expenses which will be reimbursed under this Plan shall be the lowest of:

(i) $_____ per calendar year; or

(ii) If the Employee is single or is married and earns less than his or her spouse in a calendar year, the compensation paid to the Employee by the Company as reflected on his or her Form W-2 for the year; or

(iii) If the Employee is married and the earned income of his or her spouse is less than the compensation paid to the Employee by the Company in a calendar year, the earned income of the spouse. If the spouse is a student or is physically or mentally incapable of caring for himself or herself, the spouse will be deemed to have earned income (for each month that the spouse is a student or incapacitated) of $200 per month if the Employee has one Dependent for whom care is provided and of $400 per month if the Employee has two or more Dependents for whom care is provided.

The Company may require that the Employee and/or his or her spouse certify to the Company the amount of such spouse's expected earned income for the calendar year in question and may require that the Employee provide documentary evidence of the amount certified in the form of an employment contract, paycheck stub, medical records (if the spouse is incapacitated) or a school enrollment form (if the spouse is a student).

c. Direct Payment in Lieu of Reimbursement. The Company may, in its discretion, pay any Expenses for Dependent Care directly to the dependent care provider in lieu of reimbursing the Employee in satisfaction of its obligations under the Plan.

d. Limitation of Benefits Paid to Prohibited Group. No more that 25% of the benefits paid under the Plan in any one calendar year shall be provided for the class of individuals (or their spouses or dependents) each of whom owns more than 5% of the stock of the Company, determined in accordance with Code sections 1563(d) and (e) without regard to Code section 1563(e)(3)(C), on any one day of that calendar year. If the benefits payable under the Plan to such class exceeds the limits of this paragraph, the benefits paid to each individual member of the class shall be reduced proportionately.

6. Funding Method. The benefits provided under the Plan are funded entirely out of the general assets of the Company.

7. Notification of Terms of Plan. A copy of the Plan shall be given to all Employees.

8. Statement of Benefits. On or before January 31 of each year, the Company shall furnish each Employee who received benefits under the Plan a written statement showing the amounts paid or the expenses incurred by the Employer in providing Dependent Care assistance under the Plan for the prior calendar year.

9. Amendment or Termination. The Company may amend or terminate the Plan at any time; provided, however, that any such amendment or termination shall not affect any right to benefits arising prior to such amendment or termination or shall cause benefits paid hereunder not to qualify as dependent care assistance under Code section 129.

10. Governing Law. This Plan and the rights of all persons under the Plan shall be construed in accordance with and under applicable provisions of the Internal Revenue Code of 1954, as amended, ERISA and the laws of the State of California.

[Note: The following provisions should be added if the plan is an "employee benefit plan"]

11. Fiduciary Responsibility and Plan Administration.

a. Plan Sponsor and Plan Administrator. The "plan sponsor" and the "administrator" of the Plan, within the meaning of the Employee Retirement Income Security Act of 1974 ("ERISA"), is the Company.

b. Named Fiduciary. The Company is the named fiduciary responsible for the operation and administration of the Plan.

c. Assignment of Duties. The duties of the Company hereunder shall be carried out in its name by its executive committee, officers and employees. The Company may designate any person to carry out fiduciary responsibilities under the Plan pursuant to a written instrument which specifies the fiduciary responsibilities assigned to each

such person. Any person may serve in more than one fiduciary capacity with respect to the Plan.

d. Employment of Advisors. The Company or a fiduciary designated by the Company, may employ one or more persons to render advice with regard to its fiduciary responsibilities under the Plan.

12. General Plan Information.

a. Employer Identification Number. The Employer Identification Number assigned to the Company by the IRS is: _____.

b. Plan Number. The Plan Number assigned to the Plan by the Company is: ___.

c. Plan's Fiscal Year. The date of the end of the year for purposes of maintaining the Plan's fiscal records is: _____.

d. Agent for Service of Legal Process. The agent for service of process with respect to the Plan is: _____ _____.

TO RECORD THE ADOPTION OF THE PLAN, the Company has caused this document to be executed by its duly authorized officer this ____ day of ____.

ABC CORPORATION

By_____
Its

SUMMARY OF FEDERAL AND CALIFORNIA TAX PROVISIONS RELATING TO CHILD CARE

Prepared by
Barbara B. Creed and Deene Goodlaw Solomon
of
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NOTE: THIS SUMMARY IS PROVIDED AS GENERAL INFORMATION. EMPLOYERS AND EMPLOYEES SHOULD CONSULT THEIR OWN ATTORNEYS OR OTHER TAX ADVISORS ABOUT THEIR INDIVIDUAL TAX SITUATION.

I. FEDERAL INCOME TAX INCENTIVES.

A. Costs Incurred by Employees: Child Care Credit.

1. Internal Revenue Code Section 44A provides for a limited credit against income tax for certain "employment related" child and dependent care expenses incurred by employees.

2. Amounts paid for the care of qualified individuals, which includes dependent children under 15 years of age, incurred to enable the taxpayer to be gainfully employed are defined as "employment related" expenses.

3. If the child is cared for in a "dependent care center," amounts paid for care by the center will be an employment related child care expense if the center meets applicable state and local requirements. Internal Revenue Code Section 44A(c)(2)(C) defines a dependent care center as one which cares for more than six children (other than children who live on the premises). Under California regulations, licensing is required if more than six children are cared for including children who live on the premises. Thus, in California the cost of care in a child care center with less than six "outside" children apparently will be eligible for the credit even though the center may violate California licensing requirements.

4. The employee can take a credit against federal income tax of a portion of the employment related child care expenses. The amount of the credit depends upon the adjusted

January, 1983

gross income shown on the federal income tax return of the employee.* If adjusted gross income of the employee is under $10,000, the credit is 30% of employment related child care expenses. The credit is reduced by 1% for each $2,000 or fraction thereof by which adjusted gross income exceeds $10,000 up to $28,000 of adjusted gross income. Employees with adjusted gross income of $28,000 or more will be entitled to a credit of 20% of employment related child care expenses. The maximum amount of employment related child care expenses to which the credit can be applied, however, is $2,400 for one child and $4,800 for two or more children.

5. Internal Revenue Code Section 44A(e) limits the credit to the amount of earned income of the lowest paid spouse, and provides a special rule for spouses who are students or incapable of caring for themselves. Single parents who are students are not eligible for the child care credit.

B. Cost of Employer Provided Child Care: Dependent Care Assistance Programs.

1. Taxability to Employee.

a. The cost of child care provided by the employer under a "dependent care assistance program" will not be taxed to the employee. Internal Revenue Code Section 129(a) limits the nontaxable benefit to an amount equal to the earned income of an unmarried employee or, if the employee is married, the earned income of the spouse with lower earnings (even if not the employee). There is a special rule for measuring income of spouses who are students or are disabled.

b. Under a dependent care assistance program, the employer may actually provide child care, may contract with third parties for child care services for its employees, or may reimburse employees for child care expenses. Internal Revenue Code Section 129(e)(1). Payments to a dependent of the employee or a child of the employee under age 19 do not qualify, however. Internal Revenue Code Section 129(c).

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* If the employee is married, the spouses must file a joint federal income tax return in order to claim the child care credit.

c. The program must be set out in a separate written plan adopted by the employer and communicated to the employees. The employer may establish a fund or may pay costs as they arise. Internal Revenue Code Section 129(d)(1) and (4).

d. The program must not discriminate in favor of officers, owners or highly compensated employees. Members of a collective bargaining unit may be excluded, however, if dependent care benefits were the subject of good faith collective bargaining between the employer and the union. As long as the program does not discriminate as to eligibility, the degree to which it is actually used by employees is irrelevant except as discussed below in paragraph e. Internal Revenue Code Section 129(d)(1) and (e)(6).

e. Under the program, no more than 25% of the amount paid by the employer for child care may be paid on behalf of a group made up of persons each of whom own more than 5% of the stock of the employer if it is a corporation or 5% of the profits or capital interest in an unincorporated employer. Internal Revenue Code Section 129(d)(3).

f. Amounts provided under the program are not subject to employment taxes or withholding. Internal Revenue Code Sections 3121(a)(18), 3306(b)(13), 3041(a)(18) and Social Security Act Section 209(q).

g. The employer must provide the employee with a statement of benefits under the program by January 31st of the following year. Internal Revenue Code Section 129(d)(6).

h. A dependent care assistance program may be one of the benefits offered in a "cafeteria plan" under which an employee may choose among two or more benefits. If the cafeteria plan meets the requirements of Internal Revenue Code Section 125, the benefits under the dependent care assistance program will be nontaxable to the employee who chooses it.

i. If the cost of employer provided child care does not qualify as a "dependent care assistance program," the fair market value of the employer provided child care most likely is taxable to the employee.

2. Tax Consequences to Employer.

a. Deductibility to Employer. The Internal Revenue Service has ruled that expenditures to provide child care for employees are deductible business expenses when they benefit the employer's business by reducing absenteeism and turnover. Rev.Rul. 73-348 1973-2 C.B. 31.

b. Targeted Jobs Credit. If an employer hires members of the statutorily designated target group on or before December 31, 1984 to provide child care to its employees, it may elect to take a targeted jobs credit under Internal Revenue Code Section 51. The target group generally includes economically disadvantaged persons. The credit is equal to 50% of wages for services in the first year and 25% of wages for services in the second year. Wages are limited to $6,000 per year. The employer's deduction for wages is reduced by the amount of the credit. Summer employment of economically disadvantaged youth will be eligible for a special credit effective May 1, 1982.

c. Rapid Amortization of Child Care Facilities. Section 188, which relates to rapid amortization of the cost of child care facilities, expired at the end of 1981. If an employer elected Section 188 treatment for expenditures made prior to January 1, 1982, it may continue to amortize the expenditures until the end of the 60-month period which relates to those expenditures.

II. STATE OF CALIFORNIA.

A. Costs Incurred by Employees.

1. Revenue and Taxation Code Section 17052.6 provides a credit comparable to Section 44A except that it is limited to 3% of the expenses and there is an income cap of $20,000.

2. Revenue and Taxation Code Section 17136.5 is comparable to Internal Revenue Code Section 129 and provides for exclusion from income of employees, benefits provided under a qualified dependent care assistance program of the employer.

B. Costs Incurred by Employers.

1. Revenue and Taxation Code Section 17202(a)(1) permits employers to deduct the cost of employer-provided child care. Child care is defined as programs designed to provide or facilitate the provisions of care and nurture for children under the age of 15 while their parents or guardians are working or in training.

2. Revenue and Taxation Code Section 17225.5 provides a special depreciation allowance for child development services established in convenient locations for eligible families who are employed, to be employed or enrolled in employment training programs. That section further provides that employers who establish facilities pursuant to the Education Code may compute depreciation deductions of such facilities under the straight line method using a useful life of 60 months.

3. Bank and Corporation Tax Law Section 24371.5 provides a similar depreciation deduction for employers establishing child care facilities.

About the Authors

Barbara B. Creed is a partner at Pillsbury, Madison & Sutro, San Francisco, California. She specializes in deferred compensation and employee benefits, and is the President of the San Francisco Chapter of the Western Pension Conference. She has spoken at numerous programs and seminars on employee benefits topics and is the author of ERISA Compliance: Reporting and Disclosure (Practicing Law Institute, 1981).

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